1991
ADVISORY
COUNCIL on
SOCIAL
SECURITY

Interim Report on Social Security and the Federal Budget

July 1990

Washington, D.C.

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ADVISORY COUNCIL ON SOCIAL SECURITY

July 27, 1990

The Honorable Louis W. Sullivan, M.D.
Secretary of Health and Human Services
Washington, D.C.

Dear Secretary Sullivan:

In response to your request on February 12, 1990, the 1991 Advisory Council on Social Security is issuing an interim report with recommendations on the relationship of the Social Security trust funds to Federal budget policy. I am pleased to submit the Council's interim report to you.

Also enclosed are copies of the interim report for transmittal to the Congress and the Boards of Trustees of the Federal Old-Age Insurance, Disability Insurance, Hospital Insurance and Supplementary Medical Insurance Trust Funds.

The Advisory Council is continuing its work in reviewing other aspects of the Social Security and Medicare programs and will issue its final reports as required by section 706 of the Social Security Act.

Sincerely yours,

Deborah Steelman
Chair

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FOREWORD

This interim report was prepared in response to a request from the Secretary of Health and Human Services, Dr. Louis W. Sullivan, that the 1991 Advisory Council on Social Security provide interim recommendations on the relationship of Social Security financing to Federal budget policy. This report presents interim recommendations on a subset of the full range of issues before the Council. The Council's full recommendations will be included in a final report, which is to be submitted to the Secretary and to Congress early in 1991.

Section 706 of the Social Security Act requires the Secretary of Health and Human Services to appoint an Advisory Council on Social Security every four years for the purpose of reviewing the status of the Social Security and Medicare trust funds in relation to the long-term commitments of these programs, the scope of coverage, the adequacy of benefits, and all other aspects of these programs, including their impact on the public assistance programs under the Social Security Act.[1]

Secretary Sullivan announced the appointment of the Advisory Council on June 19, 1989, and he named former Office of Management and Budget Associate Director Deborah Steelman to chair the group. In the charter for the Council,

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[1] See Appendix A for the text of Section 706.

Secretary Sullivan noted that the Council may address the following issues in addition to its statutory charge:

- The adequacy of the Medicare program to meet the health and long-term care needs of our aged and disabled population, the impact on Medicaid of the current financing structure for long term care, and recommendations for more stable health care financing for the aged, the disabled, the poor and the uninsured;

- Major Social Security financing issues, including the long-range financial status of the program, the relationship of Social Security income and outgo to budget deficit-reduction efforts under the Balanced Budget and Emergency Deficit Control Act of 1985, and projected buildups in the Social Security trust funds; and

- Broad policy issues in Social Security, such as the role of Social Security in overall U.S. retirement income policy.

On February 12, 1990, Secretary Sullivan addressed the Advisory Council and asked that the Council "...proceed with due diligence toward interim recommendations relating to ... the relationship of the Social Security trust funds to Federal budget policy."

The Council began its review of the status of the Social Security trust funds by focusing on the implications of the large buildup

in the funds that is projected to occur over the next four decades. The Council received advice from eminent scholars and policy experts as it considered issues in Social Security financing and Federal budget policy.[2] Specifically, the Council considered the implications of the trust fund buildup for:

- the economy, including the rate of national saving, and future productivity growth;
- easing the burden of financing retirement benefits for the baby boom generation;
- the soundness of Social Security financing in both the near term and the long run;
- the relationship of Social Security trust funds to the Federal budget; and
- trust fund investment policy.

This report presents the Council's interim findings and recommendations on these issues.

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[2] See Appendix B for a list of expert witnesses who addressed the Council.

MEMBERSHIP OF THE COUNCIL

Chair

Deborah Steelman, Esq.
Epstein, Becker and Green

Members

G. Lawrence Atkins, Ph.D.
Director of Employee Benefit Policy
Winthrop, Stimson, Putnam & Roberts

Robert M. Ball
Former Commissioner of Social Security

Philip Briggs
Vice Chairman of the Board
Metropolitan Life Insurance Company

Lonnie R. Bristow, M.D.
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Theodore Cooper, M.D.
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Professor John T. Dunlop
Harvard University

Karen Ignagni
Director
Department of Employee Benefits
AFL-CIO

The Honorable James R. Jones
Chairman and Chief Executive Officer
American Stock Exchange

Paul H. O'Neill
Chairman and Chief Executive Officer
Alcoa

Arthur L. Singleton
Consultant on Government

John J. Sweeney
International President
Service Employees International Union

Donald C. Wegmiller
President and Chief Executive Officer
Health One Corporation

SUMMARY OF INTERIM FINDINGS AND RECOMMENDATIONS

On questions of Social Security financing and the relationship of the trust fund buildup to the Federal budget, the Council finds:

A. The Social Security (OASDI) tax on earnings is an appropriate way to pay for Social Security benefits.

B. The Social Security system is adequately financed for the next several decades.

C. The cost of OASDI will rise beginning with the retirement of the baby boom generation.

D. The increase in the cost of Social Security that occurs as the baby boom generation retires is not expected to decline as succeeding generations retire.

E. The best way to ease the burden of paying for future retirement benefits is to increase the productive capacity of the economy.

F. Persistent large deficits in the Federal budget impede the Nation's ability to invest in the future productive capacity of the economy.

G. The buildup of reserves in the OASDI trust funds will not reduce the burden or costs of Social Security in the future unless it is used in ways that help promote economic growth.

H. The buildup of OASDI reserves, on the other hand, can help reduce the burden of supporting future retirees if the buildup increases funds available for investment to promote economic growth.

Based on these findings, the Council has the following recommendations:

Recommendation 1: The Council believes it is important to move from large Federal deficits to achieve surpluses in the total Federal budget in order to provide for a strong economy when the large baby boom generation retires. The Council supports removing Social Security from the calculation of deficit reduction targets to focus public attention on the importance of reducing the deficit in the rest of the budget in order to achieve this goal.

Recommendation 2: The Council recommends that no action now be taken to reduce revenues to the OASDI trust funds.

Recommendation 3: The Council supports the continuation of partial reserve financing of Old-Age,

Survivors, and Disability Insurance, and at the same time, urges a major reduction in the deficit in the non-Social Security portion of the Federal budget.

Recommendation 4: The Council recommends the continuation of the current policy of investing OASDI reserves in interest-bearing U.S. Treasury securities that are guaranteed as to principal and interest by the U.S. government.

BACKGROUND ON SOCIAL SECURITY

Coverage and Benefits

Social Security today covers almost all workers in the United States. About 94 percent of U.S. workers contribute to Social Security on their jobs and thus are earning credits toward their own retirement benefits. They are also gaining disability income protection for themselves and survivor benefit protection for their families in the event that they should die leaving children or widowed spouses who had relied on their support.

About 39 million people, or about 1 in 7 people in the United States, receive Social Security cash benefits each month. Retired workers and their families are the largest group, accounting for 28 million persons, while elderly widows and widowers and young families of deceased workers account for 7 million, and disabled workers and their families account for 4 million beneficiaries.

Social Security benefits are the major source of retirement income for most elderly Americans. About 60 percent of the elderly who receive Social Security count on it for at least half of their total cash income. Surveys of public attitudes show that Americans, both young and old, generally support the Social Security program and are willing to pay for it. At the same time, studies show that young persons often lack confidence that

Social Security benefits will be there for them when they retire. This Council takes very seriously its mandate to take a long-range view of Social Security and to recommend whatever actions may be needed to ensure that Americans of all ages can count on it in the future.

Financing

Income to pay for Social Security benefits is earmarked and credited to the Old-Age, Survivors, and Disability Insurance (OASDI) trust funds.[3] Trust fund income comes almost exclusively from deductions from workers' earnings and matching payments from employers; revenue from taxation of Social Security benefits; and interest earnings on the reserves that are held by the trust funds and are invested in U.S. Treasury securities.

The OASDI tax rate paid by employees and employers is 6.2 percent, each, on earnings in covered employment up to $51,300 in 1990. The amount of earnings that is subject to the tax is adjusted each year to keep pace with the growth in average wages. No future changes in the OASDI payroll tax rate are scheduled. Self-employed workers pay both the employee and employer share of the tax, and the latter share is treated as a tax deductible business expense for the self-employed, as it is for employers.

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[3] See Appendix D for definitions of terms used in this report.

The Social Security Amendments of 1983 provided, for the first time, that up to half of Social Security benefits for beneficiaries with income above specified thresholds are subject to the Federal personal income tax. The revenue from taxation of benefits goes to the OASDI trust funds.

Any trust fund revenues not immediately needed to finance current Social Security benefits are invested in interest-bearing U.S. Treasury securities. Interest earnings on these securities accrue to the trust funds.

Long-Range Projections

Each year the Board of Trustees[4] of the OASDI trust funds issues a report on the financial status of the funds. Income and outgo of the trust funds are projected over the next 75 years. Both Social Security revenue and costs will depend on demographic trends -- such as birth rates, life expectancy, and immigration rates -- and on economic trends -- such as inflation, real wage growth, unemployment, and interest rates. The Trustees make long-term projections under four different sets of assumptions about these trends. The projections

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[4] The Board of Trustees includes the Secretary of the Treasury, who servers as Managing Trustee, the Secretary of Labor, the Secretary of Health and Human Services and two members of the public, who are nominated by the President and confirmed by the Senate. The Commissioner of Social Security serves as the Secretary of the Board of Trustees of the OASDI trust funds.

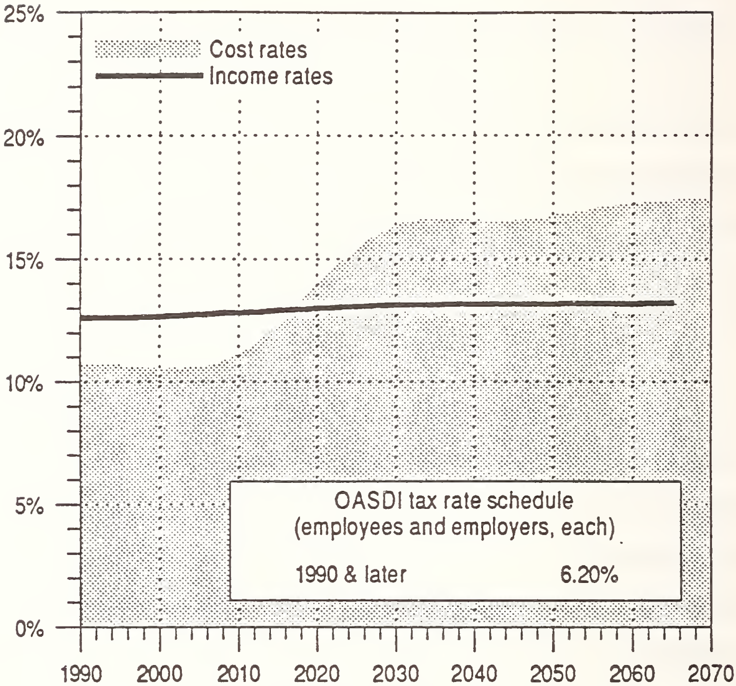
based on the intermediate (II-B) assumptions are most often used. Unless otherwise noted, the 1990 II-B projections are the ones cited in this report.

OASDI outgo, or cost, expressed as a percent of taxable payroll, is currently between 10 and 11 percent and is expected to remain between 10 and 11 percent of payroll until the baby boom generation begins to retire in about 2010. The cost will then rise rapidly to about 16 percent of taxable payroll by about 2030 and then will rise slowly to about 17 percent of taxable payroll by about 2055.

Chart 1 shows the cost of OASDI as a percent of taxable payroll over the next 75 years. These costs reflect current law, including changes already enacted that will take effect in the future, such as the provision enacted in 1983 to gradually raise the age at which full retirement benefits are paid after the turn of the century. The chart also shows trust fund income from the OASDI payroll tax and revenue from taxation of benefits. The income does not include interest earnings on the reserves.

Chart 1

OASDI Cost and Income From Tax Revenue
As A Percent of Taxable Payroll

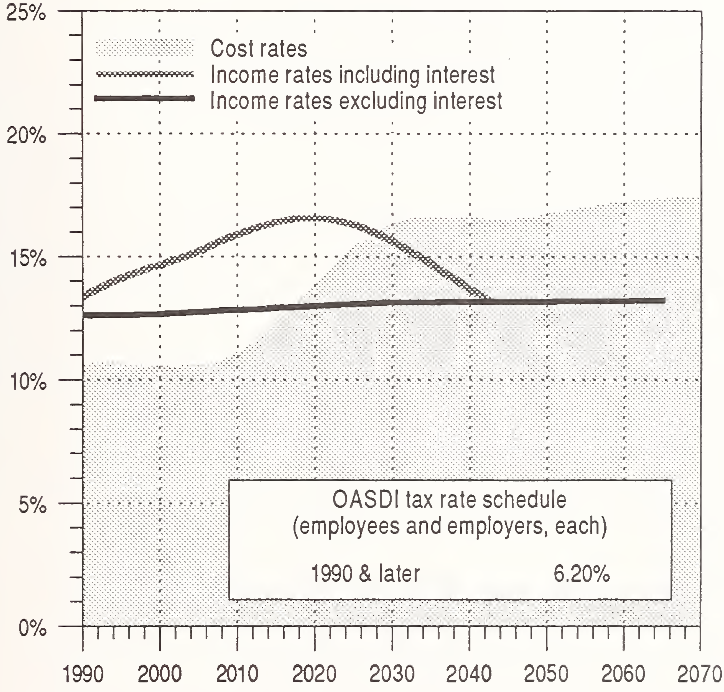


As shown, trust fund income from these sources exceeds OASDI costs through the 1990s and into the next century through 2017. During this time, the OASDI trust funds will build growing reserves through additions to the principal amount in the trust funds. The growing trust fund reserves will yield interest earnings that can be used to help meet future benefits costs. When interest earnings on the reserves are taken into account,

total trust fund income (revenue as shown in Chart 1, plus interest earnings on the reserves) will continue to exceed OASDI outgo from 2017 through 2027, as shown in Chart 2.

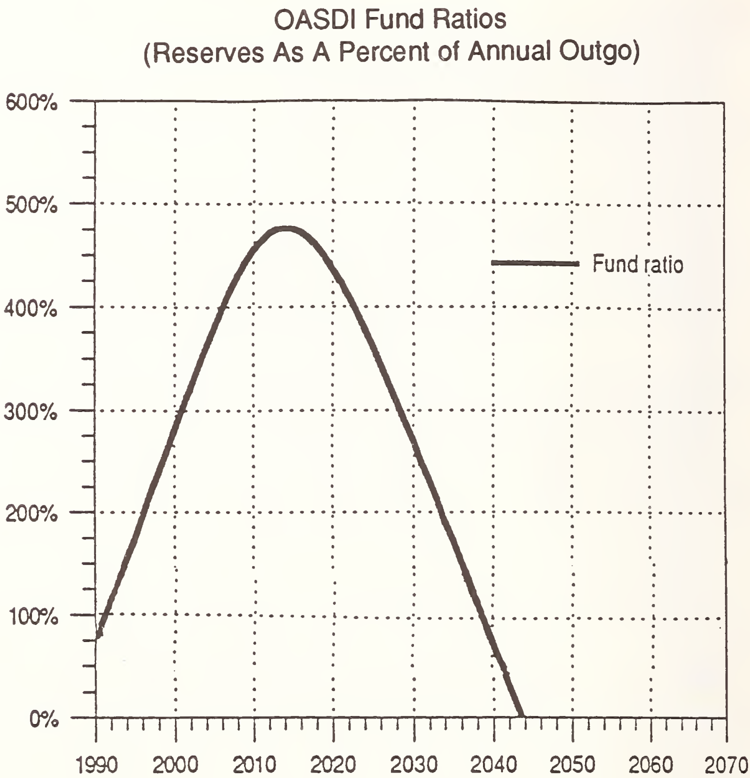
Chart 2

OASDI Cost and Total Income, Including Interest, As A Percent of Taxable Payroll



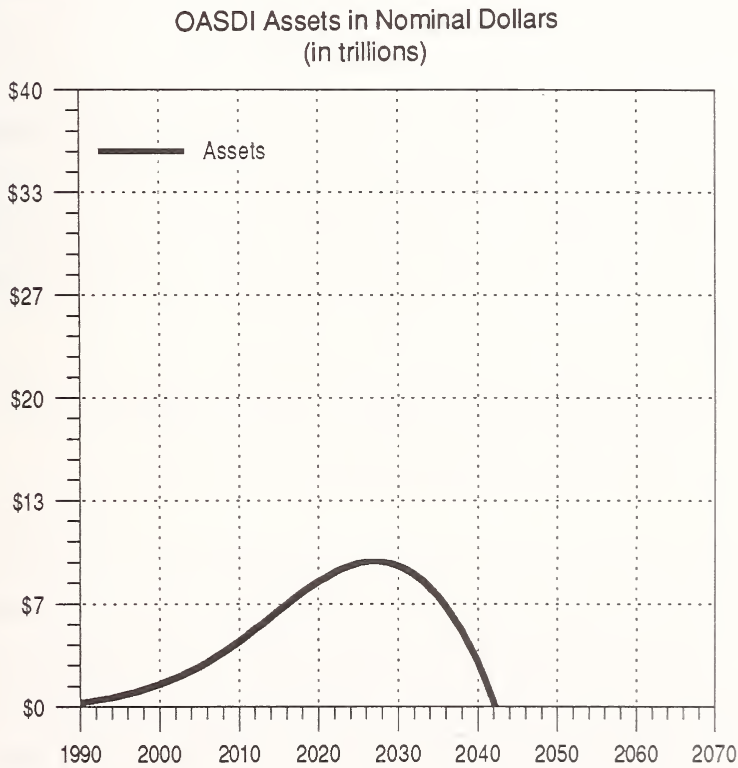
The excess of total income over outgo causes the trust fund assets, or reserves, to grow rapidly. The reserves are projected to grow from 74 percent of annual outgo at the beginning of 1990 to about 94 percent of outgo at the beginning of 1991 and will continue to rise to about 476 percent of annual outgo in 2014, as shown in Chart 3.

Chart 3



The size of the reserves in nominal dollars (that is, unadjusted for the changing value of the dollar over time) will continue to grow (although not as rapidly as outgo) after 2014 until they peak at about \$9.4 trillion in 2027, as shown in Chart 4. If no further action is taken, OASDI costs will then exceed income from both revenue and interest. The reserves would be drawn down and ultimately would be depleted by about 2043.

Chart 4



FINDINGS

A. The Social Security (OASDI) tax on earnings is an appropriate way to pay for Social Security benefits.

Social Security benefits for retired and disabled workers, their families, and survivors are based on the worker's earnings from which Social Security taxes were paid. Social Security benefits replace a higher portion of past earnings for low-paid workers than for higher-paid workers, so that, overall, it is a progressive benefit system.

The use of deductions from workers' earnings up to the amount that counts for benefit purposes, along with a tax on employers' payroll, to pay for workers' own protection and that of their families is generally understood and supported by the American public and is endorsed by the Council.

B. The Social Security system is adequately financed for the next several decades.

Social Security is projected to have enough income to meet benefit payments for about the next 50 years. In fact, the OASDI trust funds are projected to have growing dollar reserves over the next 37 years. Under the Trustees' more pessimistic (III) assumptions, reserves will grow for the next 25 years, through 2015. Although the system is not in actuarial balance over the

full 75-year projection period, it is in balance over the next 50 years, under the II-B assumptions.

C. The cost of OASDI will rise beginning with the retirement of the baby boom generation.

The demographic shift that occurs when the baby boom retires causes the cost of OASDI, as a percent of taxable payroll, to rise in the next century. When the baby boom generation retires between about 2010 and 2030, the number of persons of retirement age will grow more rapidly than the number of persons of working age. This demographic shift is the result of high birth rates in the 1950s and 1960s, followed by low birth rates in the 1970s and 1980s. Projected increases in life expectancy also contribute to a larger number of retirees in the next century.

D. The increase in the cost of Social Security that occurs as the baby boom generation retires is not expected to decline as succeeding generations retire.

The shift to a lower ratio of workers to retirees is not a one-time phenomenon of the baby boom generation's retirement. Because, in the II-B projections, it is expected that birth rates will remain low and mortality rates will continue to improve, the ratio of workers to retirees is projected to remain relatively stable as the baby boom generation is succeeded by those

that follow. Thus, the cost of Social Security as a percent of payroll is not expected to decline after the baby boom generation leaves the benefit rolls; there is no peak followed by a later drop in cost.

E. The best way to ease the burden of paying for future retirement benefits is to increase the productive capacity of the economy.

The cost of the OASDI system in the future will be borne by the economy of the future. Consequently, the most important actions that we can take today to help ease the burden of meeting the future cost of scheduled benefits are those that increase future productivity.[5]

The Council believes that a strong and growing economy is the necessary underpinning for a strong Social Security system when the baby boom generation and those that follow begin to retire. Social Security is, of course, only one reason to support policies of economic growth, but from the perspective of this Advisory Council on Social Security, it is a crucial one.

The cost of Social Security will rise in any event as the proportion of the elderly in the population rises, but if the pool of

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[5] Technically, the goods and services available for consumption when the baby boom generation retires will depend not only the the productive capacity of the U.S. economy at that time, but also on the U.S. balance of trade and its position as a net borrower or net lender with other nations.

goods and services is substantially larger than at present, it will be more likely that these increased costs can be met at the same time that workers of the future enjoy an increasing standard of living. A larger "economic pie" will make it more likely that present commitments to future retirees will be honored without an undue burden on future workers.

Ways to promote economic growth include increasing investment in productive capacity, such as in plant and equipment, research and development for new technology, infrastructure, and -- probably most important of all -- investment in human resources. Only an educated and imaginative work force will be able to sustain future economic growth.

F. Persistent large deficits in the Federal budget impede the nation's ability to invest in the future productive capacity of the economy.

In the last two decades the United States has experienced relatively low levels of national saving, investment and productivity growth. During the 1980s national saving was further depressed by very large Federal deficits. These deficits divert into current consumption the savings that otherwise might be used to finance productivity-enhancing private sector investments -- such as in plant and equipment, and research and development for new technology. In addition, the large and increasing interest charges on the Federal debt limit the

Federal government's ability to support expenditures needed to restore and expand the nation's infrastructure and to make the investments in human resources, such as education and health, that are of crucial importance to future economic growth.

G. The buildup of reserves in the OASDI trust funds will not reduce the burden or costs of Social Security in the future unless it is used in ways that help promote economic growth.

If the buildup in Social Security reserves is used simply as a substitute for other fiscal policy actions -- that is, as a substitute for increasing revenues or reducing expenditures -- that are needed to reduce the Federal budget deficit, it will not contribute to economic growth. Under these circumstances the future pool of goods and services will be no larger than if there had been no partial advance funding of Social Security.

H. The buildup of OASDI reserves, on the other hand, can help reduce the burden of supporting future retirees if the buildup increases funds available for investment to promote economic growth.

A reduction in the deficit or the development of a surplus in the total Federal budget will result in an increase in national saving, which then increases funds available for investment to enhance economic growth. It is of no significance whether a

decline in the deficit or the development of a surplus arises from Social Security reserve financing or from other fiscal policy actions. It is the net balance in the total Federal budget that matters. However, if a buildup in Social Security reserves is a net addition to what would have happened in the Federal budget in the absence of the reserve buildup, increases in future productivity can be expected to result.

RECOMMENDATIONS

Based on these findings, the Council has interim recommendations in the following areas: Social Security and the budget; the method of Social Security financing; and trust fund investment policy.

Social Security and the Budget

Policy recommendations have differed over the years on whether Social Security should be included in the overall Federal budget. Social Security and other trust fund programs were first included in the Federal budget for fiscal year 1969. The 1971 Advisory Council on Social Security considered this treatment and: (a) agreed that the unified budget should continue to include the trust funds and that basic tables in the budget should continue to separately identify trust fund operations; and (b) urged that policy changes affecting the

Social Security program should be based on the objectives of the Social Security program and not on annual budget goals.

A majority of the 1983 National Commission on Social Security Reform (Greenspan Commission), on the other hand, recommended that the Social Security and Medicare trust funds (OASI, DI, HI, and SMI) be removed from the unified budget. The Social Security Amendments of 1983 provided that: for fiscal years 1985 through 1992 the operations of the four trust funds would be shown as a separate function within the Federal budget; and, beginning in fiscal year 1993, the OASI, DI and HI trust fund operations would be removed from the unifiec budget. Removal of the trust funds was intended to help insulate the programs from pressures caused by unrelated budgetary considerations.

The Balanced Budget and Emergency Deficit Control Act of 1985, also known as Gramm-Rudman-Hollings (GRH), advanced the date for removing the OASI and DI trust funds from the budget from 1993 to 1986. The 1985 Act, however, also stipulated that the trust fund operations are to be counted in determining whether GRH deficit reduction targets, which extend through fiscal year 1993, are met.

Recommendation 1: The Council believes it is important to move from large Federal deficits to achieve surpluses in the total Federal budget in order to contribute to a strong economy when the large baby boom generation

retires. The Council supports removing Social Security from the calculation of deficit reduction targets to focus public attention on the importance of reducing the deficit in the rest of the budget in order to achieve this goal.

The Council believes that a strong and growing economy is important to maintain a strong Social Security system. This will be particularly important when the large baby boom generation begins to retire in about 2010. The Council is concerned about persistent large deficits in the Federal budget because they limit the Nation's ability to enhance the future productive capacity of our economy.

The Council believes it is desirable not only to reduce the Federal deficit, but also to achieve a surplus in the total Federal budget. Such a surplus would increase national saving and reduce the Federal debt held by the public, thereby releasing funds for private investment, which could enhance the Nation's future productivity growth.

The Council believes that the growing Social Security reserves should not routinely be used simply to offset large operating deficits in the rest of the Federal budget. The Council recognizes that whether the Social Security trust funds are in or out of the Gramm-Rudman-Hollings (GRH) calculations, in and of itself, affects neither the financial soundness of the Social Security trust funds nor the performance of the economy. The

Council does believe, however, that taking Social Security out of the Gramm-Rudman-Hollings calculations will help Federal policy-makers and the American people focus on the fundamental importance of reducing the deficit and moving toward a surplus in the overall Federal budget. For these reasons, the Council recommends that the OASDI trust funds be removed from the Gramm-Rudman-Hollings calculations.

At the same time, the Council recognizes that reductions in spending, increases in revenue, or modifications in deficit reduction targets should be designed to avoid jeopardizing other essential Federal programs, including Federal investments in human resources and infrastructure, which are essential to promote future economic growth.

Method of Social Security Financing

The Council considered at some length the trade-offs between continuing the current policy of partial reserve funding of OASDI or shifting to pay-as-you-go financing after prudent reserves are achieved.

When pay-as-you-go financing -- also called "current cost financing" -- is used, income to the OASDI trust funds is designed to closely approximate outgo and maintain an adequate contingency reserve. Contingency reserves serve to ensure that benefits can be paid in the event that temporary adverse economic conditions cause trust fund income to fall

short of expectations, or outgo to exceed expectations. Most experts believe that for contingency fund purposes, reserves of 100 to 150 percent of annual outgo are desirable.

In contrast with pay-as-you-go financing, full reserve financing is a method used to finance pension obligations, in which accumulated funds are sufficient to pay all obligations incurred to date, if the plan should terminate. Full reserve financing is used to finance private pensions, but it has never been considered necessary for a compulsory government system, such as Social Security.

Partial reserve financing, also called partial advance funding, is a method of financing Social Security in which accumulated funds are more than needed as contingency reserves under pay-as-you-go, but are less than full reserves. The buildup of Social Security reserves that is projected to occur in the next several decades is a method of partial reserve financing.

Recommendation 2: The Council recommends that no action now be taken to reduce revenues to the OASDI trust funds.

Recommendation 3: The Council supports the continuation of partial reserve financing of Old-Age, Survivors, and Disability insurance, and at the same time,

urges a major reduction in the deficit in the non-Social Security portion of the Federal budget.[6]

The Council believes it is desirable to continue the policy of partial reserve financing primarily for three reasons.

First, the growing OASDI reserves provide an opportunity to increase national saving, which can enhance the future productive capacity of the economy. The Council is committed to preserving a strong Social Security system. It believes that future generations of workers will be more likely to share this commitment if they have the benefit of a strong economy and rising real incomes. In order to have the growing OASDI reserves contribute to easing the burden of supporting retirees of the future, it is necessary that the reserves represent true government saving. The buildup should not be a substitute for other actions needed to reduce the deficit in the rest of the Federal budget.

Second, partial reserve financing will help to ease the sharp increase in the OASDI tax rate that would be needed to meet sharply rising OASDI costs in the 20 years after 2010 if Social Security were financed strictly on a pay-as-you-go basis.

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6 See Additional Views at the end of this report for comments of individual Council members on this recommendation.

- Under pay-as-you-go financing, the OASDI payroll tax rate would need to rise rather quickly when the baby boom retires between about 2010 and 2030. Under current projections, the OASDI tax rate needed to match the pay-as-you-go cost would have to rise over the 20-year period by about 50 percent. The Council is concerned that such a steep rise in payroll tax rates over that relatively short period could weaken workers' willingness to meet the cost of Social Security benefits then.

- Under partial reserve financing, the rise in the payroll tax needed to finance benefits would be less steep. If the tax rate remains at 6.2 percent of payroll, it could rise much more gradually after 2010 and still adequately finance scheduled benefits because interest earnings on the reserves help meet benefit costs.

The Council recognizes that the interest earnings on the reserves represent a claim on future Federal revenues, just as interest on the Federal debt today represents such a claim today. However, if, as recommended by the Council, the growing OASDI reserves are used to reduce the Federal debt held by the public, then when interest earnings on the OASDI reserves are used to help meet benefit costs, the combined cost of paying for retirement benefits and servicing the publicly-held debt will be less than if Social Security had not been partially advance funded.

Third, partial reserve financing represents a more even balance of OASDI payroll tax burden between today's and tomorrow's workers. On an actuarial basis, if those entering the work force today were to pay only for their own Social Security benefits from their own and their employers' OASDI taxes over their lifetimes, the needed tax would be about 7 percent each, from employees and employers. Today's workers are paying slightly less than this rate today. A shift to pay-as-you-go financing would move further from this rate.

Partial reserve financing affords an opportunity for today's workers to ease the payroll tax burden their children may face. Shifting to pay-as-you-go financing, in contrast, would give today's workers lower OASDI taxes and pass on a higher OASDI tax burden to their children.

While the OASDI system is soundly financed for the next several decades, the Council recognizes that it is not adequately financed in the last 25 years of the 75-year period for which long-range projections are made. The Council believes it would be unwise to rapidly draw down trust fund reserves after they are projected to peak (in about 2027), because a rapid draw down could have an adverse effect on the economy at that time. The Council believes that adequate reserves should be maintained throughout the long-term period. It further believes that modifications in Social Security should be enacted well in advance of 2027 to enable a smooth adjustment of revenues and/or benefits to maintain adequate

financing on an ongoing basis throughout the long-term period. The Council will include proposals for such changes in its final report.

Trust Fund Investment Policy

The Social Security Act stipulates that trust fund assets shall be invested by the Managing Trustee (the Secretary of the Treasury) only in securities issued, or guaranteed as to principal and interest, by the U.S. government. The Act also provides for "special issues" of the U.S. Treasury that are available solely for trust fund investment purposes. Unlike regular Treasury securities, these "special issues" may be redeemed at any time at their face value, plus accrued interest, if the funds are needed to cover program costs. In practice, the trust funds are invested almost exclusively in these special-issue Treasury securities.

Present trust fund investment policy is based on the following principles:

- Non-intervention in decision-making in the private economy;

- Security of both principal and interest earnings on trust fund assets;

- Neutrality, to neither advantage nor disadvantage the trust funds in relation to other Federal accounts; and

- Minimal management of investments to minimize risk of conflict of interest for the Managing Trustee.

<u>Recommendation 4</u>: **The Council recommends the continuation of the current policy of investing OASDI reserves in interest-bearing U.S. Treasury securities that are guaranteed as to principal and interest by the U.S government.**

The Council finds that the current policy of investing the excess of OASDI income over outgo in interest-bearing U.S. Treasury securities is sound. The current investment policy provides a safe and fair return to the trust funds and guarantees liquidity of trust fund assets to meet program costs when needed. This policy is also consistent with the goal of building OASDI reserves to foster economic growth.

Whether the trust funds should be invested in U.S. Treasury securities or in some other financial instrument is a separate issue from the question of how Federal fiscal policies should be designed to enhance overall national investment to promote economic growth. Investment of the trust funds in U.S. Treasury securities is consistent with a variety of different fiscal policies, including:

- policies designed to achieve a total budget surplus in order to reduce the Federal debt held by the public and increase the supply of private funds available for private investment; and

- policies that include directed Federal expenditures for public investment -- such as in infrastructure, human resources and research and development -- that aim to enhance the productivity of future workers.

The Council believes it would not be appropriate to invest the OASDI trust fund reserves directly in private securities. While private investment might result in higher returns for the trust funds over some years, it would also subject the trust funds to the risk of wide fluctuations in asset values. Further, such investment could involve Federal officials directly in private business decisions. It also could result in pressure on the Managing Trustee to invest the trust funds in ways that discriminate in favor of, or against, certain industries, firms or products, for reasons wholly unrelated to the security of the trust funds.

The Council also believes it would not be appropriate to invest the trust funds in ways that produce a lower return to the trust funds than the return available from U.S. Treasury securities. For example, tax-exempt State and local government bonds, which may be used to finance investments in infrastructure, generally provide lower interest earnings than U.S. Treasury

securities because the interest earned on such bonds is exempt from Federal income taxes. Because the tax-exempt status is of no benefit to the trust funds, the lower interest on such bonds would bring a lower real return for the trust funds.

NEXT STEPS

The Council is continuing its work on other issues in its mandate to review the OASDI program. As has sometimes been done by prior Advisory Councils, this Council convened a Social Security Technical Panel of economists and actuaries to assist it in reviewing the long-range financial projections of the Social Security program. Specifically, the Panel was asked to conduct a technical review of the assumptions and methods used to project the status of the OASDI trust funds. It will report its findings to the Council in the fall of 1990.[7] The findings of the Technical Panel and any Council recommendations based on those findings will be included in the final report of the Council.

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[7] See Appendix C for a list of the members of the Social Security Technical Panel.

On Method of Financing and Related Findings

by Arthur L. Singleton

Recommendation 3 states, in part: "The Council supports the continuation of partial reserve financing of Old-Age, Survivors, and Disability Insurance . . ."

The precise language certainly has my support. But partial reserve financing should not be continued indefinitely.

Ideally, I prefer current cost (or pay-as-you-go) financing, which worked well in the past. But this is not an ideal time for reversion. That should take place after Federal funds other than trust funds have been put on a much sounder footing.

When current cost financing is restored, as I hope it will be, a contingency reserve of between 75 and 100 percent should be adequate. The Interim Report states: "Contingency reserves serve to ensure that benefits can be paid in the event that temporary adverse economic conditions cause trust fund income to fall short of expectations, or outgo to exceed expectations. Most experts believe that for contingency fund purposes, reserves of 100 to 150 percent of annual outgo are desirable." I agree with the first of those sentences, but not the second, even if that puts me at odds with most experts. The Congress tends to use most, if not all, of the time available to deal with crises. There certainly does not need to be a reserve level equal to more than nine months' benefits -- a year's at the outside -- to allow enough time to change the law to make sure Social Security benefits will be paid. An excessive buildup of the trust funds presents a tempting target to those who would use the money for other purposes. Although a risky accumulation is taking place today, a precipitous drop in trust fund income -- in light of the huge overall Federal budget problems -- would be even more hazardous.

On Method of Financing

by Karen Ignagni
and John J. Sweeney

The interim report of the Quadrennial Advisory Council contains a series of important findings and recommendations on Social Security. It assures participants and beneficiaries that the system is equitable and its financing sound for the next several decades. It appropriately recommends that Social Security be removed from the Gramm-Rudman-Hollings deficit reduction targets and that trust fund reserves no longer be used to offset deficits in the non-Social Security accounts. The report also indicates that an increased level of resources will be needed to finance the retirement costs of the baby boom generation; it recommends that the current system of partial reserve financing be continued to help the nation to meet this burden.

We disagree with this financing recommendation. While the move to partial reserve financing taken in 1983 was prudent at the time, we believe that serious consideration now should be given to returning to a "modified" pay-as-you-go system, provided two conditions are met: (1) An adequate threshold of assets (for example a 125-150 percent contingency reserve) must be reached in the system <u>before</u> any changes go into effect; and (2) Mechanisms must be developed to monitor the flow of funds into and out of the system and to maintain this level of reserves.

The majority's recommendation to continue partial reserve financing rests on the assumption that the accumulation of reserves will represent true savings which, in turn, will increase the pool of goods and services needed to finance the future generation's retirement costs. The report also states that the buildup of reserves under partial reserve financing will smooth out payroll tax increases and lower taxes in the future.

While we support the recommendation to remove Social Security from deficit reduction targets, given the seriousness of the budget crisis it may be some time before Congress is willing

to discontinue the practice of, in essence, using increases in reserves to offset deficits in non-Social Security accounts. If this judgment proves correct, then an important issue is raised with respect to the fairness of financing the Federal government's operating expenses through Social Security taxes.

We share the majority's goal of creating a stable long-term financing system; however, the actuarial projections do not indicate that partial reserve financing, alone, will accomplish this objective. Even under the partial reserve system, there remains a serious long-term financing question. A key test of whether social Security financing is adequate traditionally has been whether the fund is in "close actuarial balance." According to Social Security actuaries, the system does not now meet the traditional test of close actuarial balance over the full 75-year projection period. Assuming the Social Security payroll tax remains at 6.2 percent, reserves are projected to build up over the next two decades. But if no further action is taken, the fund will later be drawn down and ultimately will be exhausted. Thus, partial reserve financing can only delay -- not eliminate -- an increase in the payroll tax.

Since partial reserve financing will not solve the long-term Social Security financing problems, and will not reduce short-term contribution rates, we would recommend returning to a pay-as-you-go system, with the caveat that the contingency reserve of 125-150 percent of annual outgo be maintained in the system at all times.

On the issue of whether a modified pay-as-you-go system would be dangerously reminiscent of the situation that led up to the 1983 crisis, we are convinced that it would not. We are proposing that a generous contingency reserve be maintained at all times in the system. Unfortunately, there was no such requirement prior to 1983. In 1977, the fund reserve had declined to 47 percent of annual outgo, dropping to only 7 percent in 1983 and precipitating the change to partial reserve financing. Under a modified pay-as-you-go system, this situation would not have been allowed to occur.

For all these reasons, we believe consideration should be given to returning to a modified pay-as-you-go system for Social Security. Recently, a number of key social policy analysts have recommended maintaining partial reserve financing so that there would be revenue available to handle the projected shortfall in Medicare's Hospital Insurance Trust Fund. While it is clear that this trust fund is not adequately financed for the long-term, we believe that, notwithstanding the need for short-term borrowing among funds, the question of how to structure the long-term financing of Medicare and Social Security should be handled separately. Specifically, the Medicare question should only be addressed in the context of overall health care financing issues.

APPENDICES

A. Mandate for the Advisory Council (Section 706 of the Social Security Act)

B. Expert Witnesses on Social Security Financing, the Budget and Investment Policy

C. Social Security Technical Panel Membership

D. Definitions

MANDATE FOR THE ADVISORY COUNCIL

Section 706 of the Social Security Act

SEC. 706 (a) During 1969 (but not before February 1, 1969) and every fourth year thereafter (but not before February 1 of such fourth year), except as provided in subsection (e), the Secretary shall appoint an Advisory Council on Social Security for the purpose of reviewing the status of the Federal Old-Age and Survivors Insurance Trust Fund, the Federal Disability Insurance Trust Fund, the Federal Hospital Insurance Trust Fund, and the Federal Supplementary Medical Insurance Trust Fund in relation to the long-term commitments of the old-age, survivors, and disability insurance program and the programs under parts A and B of title XVIII, and of reviewing the scope of coverage and the adequacy of benefits under, and all other aspects of, these programs, including their impact on the public assistance programs under this Act.

(b) Each such Council shall consist of a Chairman and 12 other persons, appointed by the Secretary without regard to the provisions of title 5, United States Code, governing appointments in the competitive service. The appointed members shall, to the extent possible, represent organizations of employers and employees in equal numbers and represent self-employed persons and the public.

(c)(1) Any Council appointed hereunder is authorized to engage such technical assistance, including actuarial services, as may be required to carry out its functions, and the Secretary shall, in addition, make available to such Council such secretarial, clerical, and other assistance and such actuarial and other pertinent data prepared by the Department of Health and Human Services as it may require to carry out such functions.

(2) Appointed members of any such Council, while serving on business of the Council (inclusive of travel time) shall receive compensation at rates fixed by the Secretary, but not

exceeding $100 per day and, while so serving away from their homes or regular places of business, they may be allowed travel expenses, including per diem in lieu of subsistence, as authorized by section 5703 of title 5, United States Code, for persons in the Government employed intermittently.

(d) Each such Council shall submit reports (including any interim reports such Council may have issued) of its findings and recommendations to the Secretary not later than January 1 of the second year after the year in which it is appointed, and such reports and recommendations shall thereupon be transmitted to the Congress and to the Board of Trustees of each of the Trust Funds. The reports required by this subsection shall include--

(1) a separate report with respect to the old-age, survivors, and disability insurance program under title II and of the taxes imposed under sections 1401(a), 3101(a), and 3111(a) of the Internal Revenue Code of 1954,

(2) a separate report with respect to the hospital insurance program under part A of title XVIII and of the taxes imposed by sections 1401(b), 3101(b), and 3111(b) of the Internal Revenue Code of 1954, and

(3) a separate report with respect to the supplementary medical insurance program established by part B of title XVIII and of the financing thereof.

After the date of the transmittal to the Congress of the reports required by this subsection, the Council shall cease to exist.

(e) No Advisory Council on Social Security shall be appointed under subsection (a) in 1985 (or in any subsequent year prior to 1989).

EXPERT WITNESSESS BEFORE THE COUNCIL

On Social Security Financing, the Budget and Trust Fund Investment Policy

Henry J. Aaron
Senior Fellow
Brookings Institution
(Chairman, 1979 Advisory Council)

Harry Ballantyne
Chief Actuary
Social Security Administration

Gary Burtless
Senior Fellow
Brookings Institution

Bartlett Derrick
Office of Cash and Debt Management
Department of Treasury

Robert J. Myers
Consultant
(Chief Actuary of Social Security, 1947 - 1970)

Rudolph G. Penner
Senior Fellow
The Urban Institute
(Director, Congressional Budget Office, 1983 - 1987)

Isabel Sawhill
Senior Fellow
The Urban Institute

Lawrence H. Thompson
Assistant Comptroller General
General Accounting Office

Paul Van de Water
Chief, Projections Unit
Congressional Budget Office

Carolyn Weaver
Director, Social Security and Pension Project
American Enterprise Institute

SOCIAL SECURITY TECHNICAL PANEL MEMBERSHIP

Chair

Steven Kellison, F.S.A.
College of Business Administration
Georgia State University

Economists

Peter Diamond
Massachusetts Institute of Technology

Michael Hurd
State University of New York -- Stony Brook

Alicia Munnell
Federal Reserve Bank of Boston

Lawrence Summers
Harvard University

Finis R. Welch
Unicon Research Corporation

Actuaries

Donald S. Grubbs, Jr.
Grubbs and Company, Inc.

Sam Gutterman
Price Waterhouse

Warren R. Luckner
Society of Actuaries

DEFINITIONS

The following concepts are used in this report.

Social Security means the Old-Age and Survivors Insurance and the and Disability Insurance (OASDI) programs that provide monthly benefits to retired and disabled workers and their families and to survivors of insured workers.

In this report, "Social Security" does not include other programs administered by the Social Security Administration, such as Supplemental Security Income, or other programs provided for in the Social Security Act, such as Medicare.

OASDI trust funds are the OASI and DI Trust Funds. Income to the OASDI trust funds comes mainly from: the OASDI portion of the payroll tax; income from taxation of Social Security benefits of beneficiaries; and interest earnings on reserves that are held by the trust funds and are invested in U.S. Treasury securities. Outgo from the OASDI trust funds pays Social Security benefits and the cost of administering the program.

Social Security reserves, or funds, are the accumulated assets, or balance, in the OASDI trust funds.

Contingency fund, or contingency reserve, is a balance in the OASDI trust funds, for the purpose of ensuring that benefits can be paid in the event that temporary adverse economic conditions cause trust fund income to fall short of expectations, or outgo to exceed expectations.

Fund ratio, or reserve ratio, is the balance of the OASDI trust funds, expressed as a percentage of projected outgo over the next 12 months. For example, a 100 percent fund ratio means that the balance on hand is equal to one year's outgo.

Surplus is the amount by which income exceeds outgo in a year. An annual surplus in the total Federal budget reduces the

Federal debt held by the public (that is, by all investors in Federal securities other than Federal trust funds).

Deficit is the amount by which outlays exceed income in a year. An annual deficit in the total Federal budget adds to the Federal debt.

Federal debt is the accumulated obligations of the Federal government from borrowing from all sources, including from Federal trust funds. The Federal publicly-held debt is the government's accumulated obligations from borrowing from all sources other than Federal trust funds -- that is from private U.S. investors or foreign interests.

Total Federal budget is the budget of the Federal government including the OASDI trust funds.

Non-Social Security budget is the total Federal budget excluding the operations of the OASDI trust funds.